

Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Use of Hybrid Method by Construction Contractors

Issue: May construction contractors (contractors) compute taxable income using the cash receipts and disbursements method except for purchases and sales when the contractors are providing substantial services while also producing, purchasing, or selling merchandise as an income producing factor in their businesses?

Conclusion: Contractors may compute taxable income using the cash receipts and disbursements method except for purchases and sales when the contractors are providing substantial services while also producing, purchasing, or selling merchandise as an income producing factor in their businesses.

Law: The regulations provide that a taxpayer is required to use inventories in every case in which the production, purchase, or sale of merchandise is an income producing factor. See §§ 1.446-1(a)(4)(i) and 1.471-1. Section 1.446-1(c)(2)(i) provides that in any case in which it is necessary to use an inventory, an accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized. However, under § 1.446-1(c)(1)(iv) a taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash receipts and disbursements method in computing all other items of income and expense.

Discussion: Sections 1.446-1(c)(2)(i) and 1.446-1(c)(1)(iv) only require a taxpayer to use an accrual method with regard to purchases and sales. It is implicit that a taxpayer

that selects to do so may use another accounting method, such as the cash receipts and disbursements method, for its other activities if the combination of methods clearly reflects the taxpayer's income. This combination of methods, referred to as a "hybrid method", is used by many contractors.

Contractors, such as plumbers and electricians, primarily provide services. While providing services, contractors, at times, also provide inventorable items. Confusion has occurred when a contractor provides inventorable items in connection with services. In this situation, it could be argued that an overall accrual method must be used by the contractor, because an inventory is needed.¹ This argument fails to recognize that the regulations only require that an accrual method of accounting be used for purchases and sales and that the regulations specifically permit a taxpayer that is using an accrual method for purchases and sales to use any other method, such as the cash receipts and disbursements method, to compute all other items of income and expense provided income is clearly reflected.

CC:ITA routinely grants requests by contractors to change their methods of accounting so that they use the hybrid method set out in § 1.446-1(c)(1)(iv); an accrual method to reflect income and expenses associated with inventorable items with the cash receipts and disbursements method to reflect the income and expenses associated with services. Combining an accrual method for inventorable items with the cash receipts and disbursements method for services reflects both the contractors' activities as well as the regulations' requirements. This ruling position has not been applied to contractors, except for tax shelters, with average annual gross receipts of \$5 million or less prior to 2018 (\$25 million currently, adjusted for inflation) as they are allowed to use the cash receipts and disbursements method for all their activities.²

¹ But see CC-2001-010, expired April 18, 2014, in which the Office of Chief Counsel announced that it would no longer litigate the issue of whether contractors had inventorable items or needed to use an accrual method.

² Tax Cuts & Job Act (TCJA) increased the § 448 gross receipts test to \$25 million for taxable years after 2017, and also added an exception to the inventory requirements under § 471(c)(1)(B) for taxpayers meeting the § 448 gross receipts test.